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December 24, 1991

Re: Change In Ownership - Leases

Dear

This is in response to your letter of October 24, 1991, to Mr. Richard Ochsner, Assistant Chief Counsel, in which you request our opinion regarding the change in ownership implications of various hypothetical lease transactions. The examples and questions given below are taken from your letter.

Section 60 of the Revenue and Taxation Code (all section references contained herein are to the Revenue and Taxation Code) states that:

A "change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.

Included within the definition of change in ownership is:

- (1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options); or (2) any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years. (section 61(c)).

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As a counterpart to Section 61(c), Section 62(g) specifically excludes from the definition of a change in ownership:

Any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of 35 years or more.

These statutory provisions are interpreted by subdivision (f) of Property Tax Rule 462, which provides, in pertinent part:

- (1) The following transfers of either the lessee's interest or the lessor's interest in taxable real property constitute a change in ownership of such real property:

(A) Lessee's Interest:

- (i) The creation of a leasehold interest in real property for a term of 35 years or more.
- (ii) The transfer, sublease, or assignment of a leasehold interest with a remaining term of 35 years or more.
- (iii) The termination of a leasehold interest which had an original term of 35 years or more.

(B) Lessor's Interest:

- (i) The transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of less than 35 years.
- (ii) The transfer of a lessor's interest in taxable real property subject to multiple leases, one or more of which is for a remaining term of less than 35 years and one or more of which if for a remaining term of 35 years or more, in which case there is a change in ownership of the portion of the property subject to the lease(s) with a remaining term of less than 35 years.

- (2) The following transfers of either the lessee's interest or the lessor's interest in taxable real property do not constitute a change in ownership of such real property.

(A) Lessee's Interest:

- (i) The creation of a leasehold interest in real property for a term of less than 35 years.
- (ii) The transfer, sublease, or assignment of a leasehold interest with a remaining term of less than 35 years (regardless of the original term of the lease).
- (iii) The termination of a leasehold interest which had an original term of less than 35 years.

(B) Lessor's interest:

- (i) The transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or more, whether to the lessee or another party.
- (3) Once a change in ownership of taxable real property subject to a lease has been deemed to have occurred, the entire property subject to the lease is reappraised (i.e., the value of both the lessee's interest and the reversion).
- (4) The calculation of the term of a lease for all purposes of this section shall include written renewal options.

The rationale behind the foregoing provisions was stated by the Task Force on Property Tax Administration in pertinent part as follows:

The "value equivalence" test is necessary to determine who is the primary owner of the property at any given time. Often, two or more people have interests in a single parcel of real property. Leases are a good example. The landlord owns the reversion; the tenant, the leasehold interest. Suppose the landlord sells the property subject to the lease and the lessee

assigns the lease. Which sale or transfer is the change in ownership?

The example illustrates that in determining whether a change in ownership has occurred it is necessary to identify but one primary owner. Otherwise assessors would be forced to value, and account for separate base year values for landlords and tenants on all leases, and for other forms of split ownership. This would enormously complicate the assessor's job.

A major purpose of this third element [i.e., the "value equivalence" element], therefore, is to avoid such unwarranted complexity by identifying the primary owner, so that only a transfer by him will be a change in ownership and when it occurs the whole property will be reappraised. If the hypothetical lease previously mentioned was a short term lease (the landlord owned the main economic value), the landlord's sale, subject to the lease would count. If, on the other hand, the lease was a long term lease (the lessee's interest was the main economic package), the lease assignment would count. In either case, the entire fee value of the leased premises would be reappraised.

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Specific Statutory Examples

1. Leases. Leases are a good illustration of the necessity of concrete statutory examples. Both taxpayers and assessors need a specific test - rather than the broad "value equivalence" test - to determine the tax treatment of leases. The specific test, however, must be consistent with the "value equivalence" rule and have a rational basis. Lenders will lend on the security of a lease for 35 years or longer. Thus 35 years was adopted as the concrete dividing line. If the term of a lease, including options to renew, is 35 years or more, the creation of the lease is a change in ownership and so is its expiration. If a lessee under such a lease assigns or sublets for a term of 35 years or more, that is another change in

ownership. However, if the lease, including options, is for less than 35 years, the lessor remains the owner and only the transfer of his interest is a change. In all cases, the entire premises subject to the lease in question are reappraised. (Report of the Task Force on Property Tax Administration, January 22, 1979, pages 39-41.)

See also, Implementation of Proposition 13, Volume 1, Property Tax Assessment, October 29, 1979, pages 19, 20, 25 and 26.

Besides explaining the rationale behind the concept of identifying the primary owner of a leasehold interest, the quotation points out that only a transfer by the primary owner will be a change in ownership. "Transfer" has been defined as "a conveyance, by sale, gift, or otherwise, of real or personal property, to another." (The Random House College Dictionary (Rev. Ed. 1984) p. 1395).

Question 1. Mere Passage of Time.

A is the sole owner of a fee interest in real property (property). A leases the property to B for a term of 40 years which constitutes a change in ownership. Due to the passage of time, six years on the lease have expired, there is a remaining term of 34 years.

Does the reduction in the lease term from 40 years to 34 years due to the passage of time constitute a change in ownership requiring a revaluation of the property?

Answer

By statute, when the remaining term of a leasehold interest for a term of 35 years or more falls below 35 years as in this case, 34 years, primary ownership of the leasehold shifts from the lessee to the lessor, as explained above. A change in ownership at this point does not occur, however, because there has been no transfer of the lessor's interest. Without a transfer, the real property cannot undergo a change in ownership. Therefore, no reappraisal would take place in this example.

Question 2. Transfer of Fee Interest.

A. A leases the property to B for a term of less than 35 years which does not constitute a change in ownership. Subsequently, A transfers the property to either a third party or to B, the lessee.

Does the transfer constitute a change in ownership requiring a revaluation of the property? Does it matter if A transfers the property to a third party or to B, the lessee?

Answer

The transfer of the lessor's interest in real property subject to a lease with a remaining term of less than 35 years constitutes a change in ownership, and revaluation of the property would occur. It doesn't matter if lessor transfers the property to a third party or to the lessee; the transfer results in a change in ownership.

B. A leases the property to B for a term of more than 35 years which constitutes a change in ownership. Subsequently, A transfers the property to either a third party or to B, the lessee.

Does the transfer constitute a change in ownership requiring a revaluation of the property? Does it matter if A transfers the property to a third party or to B, the lessee? Does it matter if the remaining term of the lease at the time of the transfer is more or less than 35 years?

Answer

The transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or more, whether to a third party or to the lessee, does not constitute a change in ownership. It does matter if the remaining term of the lease at the time of the transfer is more or less than 35 years, as discussed above.

Question 3. Extensions and Amendments.

A. A leases the property to B for a term of 30 years which does not constitute a change in ownership. After four years have expired on the lease, A and B amend the lease to extend the term an additional 10 years, leaving a remaining term of 36 years. The extension was not

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pursuant to an option granted at the time of the original lease but constituted a subsequent amendment of the lease.

Does the amendment result in a change in ownership requiring a revaluation of the property?

Answer

The amendment would cause a change in ownership because it increased the lease term to more than 35 years thus, the amendment creates a leasehold interest of more than 35 years. Primary ownership of the leasehold shifts from the lessor to the lessee, since the lessee has 36 years remaining on the lease, as amended. There would be a revaluation of the property.

B. A leases the property to B for a term of 30 years which does not constitute a change in ownership. After six years have expired on the lease, A and B amend the lease to extend the term an additional 10 years, leaving a remaining term of 34 years. The extension was pursuant to a lease amendment, not the exercise of an option granted with the original lease term.

Does the amendment result in a change in ownership requiring a revaluation of the property?

Answer

The amendment would not cause a change in ownership because the lease term is less than 35 years both before and after the amendment. Therefore, primary ownership of the leasehold would remain with the lessor and there would not be a revaluation of the property.

C. A leases the property to B for a term of 40 years which constitutes a change in ownership. After six years have expired on the lease, A and B amend the lease to extend the term an additional 10 years, leaving a remaining term of 44 years. The extension was pursuant to a lease amendment, not the exercise of an option granted with the original lease term.

Does the amendment result in a change in ownership requiring a revaluation of the property?

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Answer

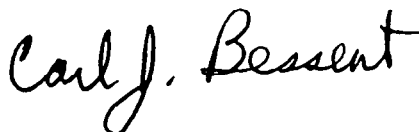
When a lease is amended to extend the term an additional ten years, the new lease term is then measured by the 35-year test to determine if beneficial ownership of the real property has changed.

When the lessee with a remaining term of less than 35-years extends or enters into a new lease term with the lessor, who is at this point considered the primary owner of the leasehold, a transfer occurs if that new lease term equals 35-years or more. Since the new lease term is extended from 34 years to 44 years due to the amendment, creating a new leasehold interest of more than 35 years, a transfer and change in ownership occurred and there would be a revaluation of the property.

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county. You may wish to consult appropriate county assessors to confirm that they view the hypothetical lease transactions and the change in ownership consequences thereof, discussed above, as we do.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

A handwritten signature in cursive script that reads "Carl J. Bessent".

Carl J. Bessent
Tax Counsel

CJB:jd
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